No. 13,239

IN THE

United States Court of Appeals

For the Ninth Circuit

BEN A. PUENTE and MARION PUENTE, *Petitioners,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	}

On Petition to Review a Decision of The Tax Court of the United States.

BRIEF FOR PETITIONERS.

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BRIEF FOR PETITIONERS.

STATEMENT OF THE CASE.

This is a petition to review a determination of The Tax Court of the United States that there is a deficiency in income and victory tax for the year 1943 in the amount of $191.66 due from the petitioners. (R. 22.) The petition has been timely and properly filed in this Court of Appeals under the provisions of Sections 1141 and 1142 of the Internal Revenue Code (Pt. 1, 53 U. S. Stat. at L.; Title 26, U. S. Code), as last amended by section 128 of the Act of May 24, 1949 (Ch. 139, Sec. 128, 63 U. S. Stat. at L. 107; Suppl. IV, U. S. Code, 1946 Ed., p. 1317).

The memorandum findings of fact and opinion of The Tax Court, the pertinent parts of which are copied in the transcript of record, pp. 17-21, have been printed in full at 10 T.C.M. 735.

The deficiency asserted by the respondent Commissioner of Internal Revenue and confirmed by the decision of The Tax Court results from the refusal of the respondent to allow a timely filed claim for refund of all of the income and victory tax paid by the petitioners for 1943, which claim was based on a carry-back under the provisions of Section 122, Internal Revenue Code, of a net operation loss of $2,601.99 sustained by them in the year 1945. The respondent's denial of the claim was based on his holding that the losses sustained by the petitioners on the sale of dairy cattle and equipment in 1945 "were not attributable" to the operation of their dairy business in that year. (R. 13, 15, 25.)

FACTS INVOLVED.

The facts pertaining to the issue in this case have been stipulated. (R. 23-25.) They are summarized as follows:

During the calendar year 1945 the petitioners were engaged in the dairy farming business on a rented farm near Lodi, California. The petitioners' herd of dairy cattle and the farming and dairy equipment required for the operation of their said business had been bought on credit when the business was started

late in 1944. Their debt for part of the purchase price thereof was secured by a chattel mortgage thereon to the vendor of the cattle and equipment. In the year 1945 forced sales were made of the petitioners' said cattle and equipment at the insistence of the holder of the chattel mortgage thereon. The sales resulted in losses of $4,498.82 and $75.48 on the cattle and equipment respectively in relation to the bases for loss or gain on such sales under the income tax law. The petitioners' ordinary receipts from farm produce sold and from wages for the year 1945 amounted to $8,917.27; and their expenses for rent, feed, labor, supplies, and other direct operating expenses, and allowable depreciation amounted to $6,944.36. The net profit from their dairy business, exclusive of the losses on the sales of cattle and equipment, is the difference between those sums, $1,972.91. Subtracting that profit from the total losses on the sale of cattle and equipment, $4,574.30 ($4,498.82 plus $75.48), there is obtained the net loss of $2,601.39 claimed by the petitioners as a net operating loss for 1945 according to the provisions of Section 122, Internal Revenue Code. (R. 23, 24; Cf. Par. (f) of petition to The Tax Court, R. 7.)

QUESTION PRESENTED.

Only a single question of law is presented on this petition for review, namely:

> Are the petitioners entitled to a deduction of $2,601.39 on their 1943 income tax return by

reason of a net operating loss sustained for the calendar year 1945 under Section 122, Internal Revenue Code?

The essential facts in the computation of the claimed loss, including the fact that "the petitioners were in the business of operating a dairy farm" during the year 1945, have been stipulated. The determination by The Tax Court of that question adverse to the petitioners hinges on the interpretation of the phrase "not attributable to the operation of a trade or business" contained in Section 122(d)(5) of the Internal Revenue Code, which section excludes, in effect, a "carry-back" or "carry-over" produced by deduction "not attributable to the operation of a trade or business regularly carried on by the taxpayer." The petitioners' position is that their losses on the sales of cattle and equipment in 1945 were fully "attributable" to the operation of their dairy farm.

ARGUMENT.

In their argument the petitioners propose to show:

I. The modification by the Revenue Act of 1942 of the operating loss deduction to include "carry-backs" of losses was a relief measure to be construed liberally in favor of taxpayers.

II. The history of the net operating loss provisions of the income tax law indicates no intention to exclude from the "net operating loss" losses incurred in the disposal of assets used in the trade or business.

III. The terms of Section 122, Internal Revenue Code, do not provide or imply that losses incurred in the disposal of assets used in the trade or business shall be excluded in computing a net operating loss.

IV. The terms of Section 122, Internal Revenue Code, do not require or imply that losses of individuals from disposal of property used in trade or business be treated differently from such losses by corporations.

INTRODUCTION.

As noted in the opinion below (R. 21) the issue in this case is substantially the same as those in cases decided adversely to the taxpayers, as follows:

Sic v. Commissioner of Internal Revenue, 177 F. (2d) 469 (C. A. 8, 1949), affirming 10 T. C. 1096; cert. den. Mar. 31, 1950; and

Baruch v. Commissioner of Internal Revenue, 178 F. (2d) 402 (C. A. 2, 1949), affirming 11 T. C. 96;

to which cases may be added two more:

Lazier v. United States, et al., 170 F. (2d) 521 (C. A. 8, 1948), affirming 77 F. Supp. 241; and

Pettit v. Commissioner of Internal Revenue, 175 F. (2d) 195 (C. A. 5, 1949).

In asking this Court of Appeals to review a question which has been answered adversely to the petitioners' contentions by three other Courts of equal

rank it behooves the petitioners to explain at the outset their reasons for going against such an apparently imposing array of precedents on the respondent's side. Those reasons are, in brief, as follows:

I. The opinions in the decided cases listed above are, in their obvious effect, contrary to the manifest policy of the Congress in enacting the net operating loss provisions of the income tax law. (Sec. 122, Internal Revenue Code.) This point will be elaborated on in the arguments under propositions I and II below.

II. These opinions, on analysis, appear to be based, in a "follow-the-leader" down a path of least resistance pattern, on two fallacious opinions of lesser authority, one the opinion of Judge Leech in *Joseph Sic,* 10 T. C. 1096, and the other that of an anonymous author of I. T. 3711, a ruling of the Bureau of Internal Revenue, printed in Cumulative Bulletin 1945 at page 162. In none of the four opinions is there evidence of any critical analysis of those two opinions accepted as basic authority. In the earliest Court of Appeals opinion, Lazier, *supra,* the affirmation of the District Court's findings was stated to be primarily on the basis of Judge Leech's opinion in 10 T. C. 1096 and the ruling in I. T. 3711, *supra.* There was no probing of the premises of those opinions but there was an expression of considerable doubt as to the correctness of the Tax Court decisions following the *Sic* case, 10 T. C. 1096. The affirmation of the District Court's findings was explicitly because of the Court's reluctance to depart from The Tax Court's doctrine. In the same Court's consideration of the same ques-

tion in the *Sic* case, 177 F. (2d) 469, its following of its prior decision in Lazier was automatic.

The Court of Appeals for the Fifth Circuit likewise expressed its doubts of the correctness of its action in the *Pettit* case, 175 F. (2d) 195, but preferred to go along with the opinion of the Court for the Eighth Circuit in the *Lazier* case. The Court of Appeals for the Second Circuit affirmed The Tax Court in the *Baruch* case, 178 F. (2d) 402, in a *per curiam* opinion on the authority of the *Lazier* and *Pettit* cases.

In view of these reasons it is urged upon this Court that the force of precedent in the cited cases is much weaker than it seems on reading the list of them, and weaker, too, than the interests of thousands of taxpayers whose losses in business are more often than not complicated with losses on the disposal of the assets by means of which their businesses are conducted. The most earnest consideration of the Court of the following arguments is bespoken in their interest.

I. THE MODIFICATION BY THE REVENUE ACT OF 1942 OF THE OPERATING LOSS DEDUCTION TO INCLUDE "CARRY-BACKS" OF LOSSES WAS A RELIEF MEASURE TO BE CONSTRUED LIBERALLY IN FAVOR OF TAXPAYERS.

In the enactment of the Revenue Act of 1942, which first of the wartime revenue measures increased the rates of tax on both individuals and corporations to the highest levels in the history of the income tax

law, the Congress saw fit in obvious consideration of the semiconfiscatory effect of the high rates to include a record number of relief provisions for a single revenue law. Principal of such provisions were as follows:

Sec. 120, alimony and separate maintenance payments deductible by payor and taxable to payee;

Sec. 127, allowance of medical, dental and similar expenses;

Secs. 150 and 151, capital gains treatment of gains from involuntary conversions and sales of property (depreciable assets and land) used in business, with full deduction for losses therefrom;

Sec. 153, provisions for carry-backs of net operating losses;

Sec. 156, liberal provisions for allowance of war losses.

Similar provisions were made in the excess-profits tax provisions of the Internal Revenue Code with respect to excess-profits credit carry-backs and carry-overs (Sec. 204 of the Act) and by the liberalization of the relief provisions of Section 722 and adding relief provisions for other special cases by Section 736 (Sec. 222 of the Act).

The statutory allowances of carry-overs of net operating losses, a history of which is sketched in the argument on Proposition II below, have always been

in the relief provision class, but with the advent of the unprecedented high tax rates and low exemptions of the Revenue Act of 1942 the expansion of the scheme of such allowances to provide carry-backs as well as carry-overs was a doubling of the relief provision attributes of the modified Section 122 of the income tax law.

In the report of the Senate Finance Committee on the provisions of the bill which was enacted as Section 153 of the Revenue Act of 1942 (Senate Report No. 1631, 77th Congress, 2d Session, C. B. 1942-2, p. 504) it is stated (p. 547, C. B. 1942-2):

> "To afford relief in these hardship cases, where maintenance and upkeep expenses, must, because of wartime restrictions be deferred to peacetime years, your committee has provided a 2-year carry-back of operating losses and of unused excess-profits credit. This provision affords, in effect, the same type of relief in periods of declining profits which the present 2-year carry-forward of operating losses and unused excess-profits credits affords in periods of increasing profits."

As a relief measure Section 122 should, as Justice Robb said in *Burnet v. Marston,* 57 F. (2d) 611 (C. A. D. C. 1932), of its predecessor, Section 204 of the Revenue Act of 1921, "be construed liberally in favor of the taxpayer to give the relief it was intended to provide", which statement was made on the authority of *Bonwit Teller & Co. v. United States,* 283 U.S. 258 (1931) 263, 51 S. Ct. 395, 397, 75 L. Ed. 1018, and four other Supreme Court cases.

II. THE HISTORY OF THE NET OPERATING LOSS PROVISIONS OF THE INCOME TAX LAW INDICATES NO INTENTION TO EXCLUDE FROM THE "NET OPERATING LOSS" LOSSES INCURRED IN THE DISPOSAL OF ASSETS USED IN THE TRADE OR BUSINESS.

The first provision the income tax law made for an allowance of a net loss from business operations in a year other than that in which it was sustained was that of Section 204(a) of the Revenue Act of 1918 for a carry-back from 1919 to 1918 of (1) losses incurred in the operation of any business and (2) losses on the sale in 1919 of real estate, manufacturing plants, machinery, or other facilities for production of war materials acquired on or after April 7, 1917. The Act also contained a provision of similar effect with respect to 1919 inventory losses. The Revenue Act of 1921 provided in Section 204(a) for carry-over to two subsequent taxable years of losses incurred in the operation of a trade or business "including losses sustained from the sale or other disposition of real estate, machinery and other capital assets used in the conduct of such trade or business". The Revenue Acts of 1924, 1926, and 1928, defined the term "net loss" with reference to the excess of deductions allowed by the income tax law over the gross income with exceptions for (1) non-business deductions in excess of non-business income, (2) capital losses in excess of capital gains, and (3) discovery or percentage depletion in excess of depletion on cost; and (4) with the inclusion in gross incomes, for the purpose of the definition, of tax-free interest received in excess of non-deductible interest paid to carry tax-

free securities. (Secs. 206, Acts of 1924 and 1926; Sec. 117, Act of 1928.)

The administrative interpretation and policy with respect to the provisions of these Acts is indicated from the introductory paragraph of Art. 651, Regulations 74 (Cf. Art. 1601, Regulations 62; Arts. 1621, Regulations 65 and 69), reading, as first approved, as follows:

> "The term 'net loss' as used in section 117 applies to a net loss during the taxable year in a trade or business regularly carried on by the taxpayer. *Included therein are losses from the sale or other disposition of real estate, machinery, and other capital assets used in the conduct of such trade or business.* See section 101 and article 503 with reference to the deduction of capital net losses. In order to be entitled to claim an allowance for a 'net loss' the taxpayer must have suffered an actual net loss in a trade or business during the taxable year. The amount properly allowed may be neither the loss reflected by the return filed for the purpose of the income tax nor the net loss shown by the taxpayer's profit and loss account, but is to be computed according to the Act." (Emphasis supplied.)

The Revenue Act of 1932 had a similar provision for a loss carry-over limited to one year after the year of the operating loss, but it never became effective due to its repeal by the National Industrial Recovery Act.

These predepression loss carry-over provisions of the income tax law were given acute consideration

in the leading case of *Edgar L. Marston,* 18 B. T. A. 558 (1929), affirmed *sub nom. Burnet v. Marston,* 57 F. (2d) 611 (C. A. D. C. 1932). That litigation involved losses by members of a security banking and brokerage partnership in 1922 with respect to partnership obligations and guarantees entered into prior to the winding up of the partnership business in 1920. The decision of the Board of Tax Appeals, affirmed on the Commissioner's petition for review, established the rule that a deductible "net loss" might be incurred in some year when the taxpayer was not actually engaged in the business, provided the loss was "attributable" to a business regularly carried on in some prior year. The affirmance in this case by the Court of Appeals of the District of Columbia was followed by the amendment of the provisions of Art. 651, Regulations 74, as quoted above, to make the first sentence read:

> "The term 'net loss' as used in section 117 applies to a net loss sustained during the taxable year and resulting from the operation of any trade or business regularly carried on by the taxpayer during the taxable year or any prior taxable year."

and to the striking out of the fourth sentence. (T. D. 4349, C. B. XI-2, p. 117, approved August 15, 1932.) The corresponding articles of prior regulations back to Regulations 62, as cited above, were similarly amended by the same Treasury Decision.

When the operating loss carry-over provisions were restored to the income tax law by the addition of

Section 122 to the Internal Revenue Code by Section 211 of the Revenue Act of 1939, they were advertised by the report of the Committee on Ways and Means (Report No. 855, 76th Congress, 1st Session, C. B. 1939-2, p. 504) as following the pattern of the provisions of the Revenue Act of 1928, in the following language (p. 508, C. B. 1939-2):

> "In the interest of equity, the committee, in the bill as reported, has recommended an amendment under which individuals and partners are allowed a 2-year carry-over of losses. This carry-over is substantially the same as that which was granted to them under the Revenue Act of 1928."

The bill as referred to the committee had provided for the carry-over of losses only in the returns of corporations.

The amendments of the provisions of this section of the Internal Revenue Code by the Revenue Act of 1942 to permit carry-backs as well as carry-overs of operating losses are negative of any change in the motivation of this legislation. These amendments were not in the bill which became the Revenue Act of 1942 as it passed in the House of Representatives, but were added by the Senate Finance Committee. Compare its report (Senate Report No. 1631, 77th Congress, 2d Session, C. B. 1942-2, p. 504) at pp. 546, 547, C. B. 1942-2, where the provision of a loss carry-back provision is characterized as a relief provision, and at pp. 596, 597, C. B. 1942-2, where the detailed discussion of its provisions is utterly negative of any indication of legislative intent to limit or restrict the

former provisions for the carry-over of net operating losses.

The language of the provisions of Section 122, Internal Revenue Code, when compared with that of the corresponding provisions of Section 117, Revenue Act of 1928, the last predepression operating loss deduction enactment, shows no change indicative of any difference of legislative intent. As will be shown in the argument below under Proposition III, the diversity of interpretation had its origin to a marked extent, in an attempt, quite successful to this date, on the part of the Bureau of Internal Revenue to pervert the intent of the Congress to its own theory of how much relief should be accorded to a taxpayer who has suffered a loss in his trade or business.

III. THE TERMS OF SECTION 122, INTERNAL REVENUE CODE, DO NOT PROVIDE OR IMPLY THAT LOSSES INCURRED IN THE DISPOSAL OF ASSETS USED IN THE TRADE OR BUSINESS SHALL BE EXCLUDED IN COMPUTING A NET OPERATING LOSS.

If the position of the respondent, as stated in his statutory notice, "that the losses sustained * * * on the sale of dairy cattle and equipment in 1945 were not attributable to the operation of your dairy business" (Cf. Stip. 10) is to be justified in the terms of the statute such justification must be found in Section 122(d)(5), Internal Revenue Code, which reads, in part:

> "(5) Deductions otherwise allowed by law *not attributable* to the operation of a trade or busi-

> ness regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the gross income not derived from such trade or business." (Emphasis supplied.)

The comparable provision of the last of the predepression Revenue Acts is shown by Section 117(a)(1) of the Revenue Act of 1928, which reads:

> "(1) Non-Business Deductions: Deductions otherwise allowed by law *not attributable* to the operation of a trade or business regularly carried on by the taxpayer shall be allowed only to the extent of the amount of the gross income not derived from such trade or business." (Emphasis supplied.)

Obviously the meaning and application of the limitation of deductions in the case of each statute are determined by the words "not attributable". A dictionary definition of the verb "attribute" is "to ascribe by way of cause, inherent quality, interpretation, authorship, or classification" (Webster's Collegiate Dictionary, Fifth Edition), a term of causation nearly, if not quite, as general in its significance as "relate" or "refer", and more general than "ascribe" or "impute". If the words "attributable" and "attribute" have not acquired some special and technical meaning in connection with income tax law (and diligent search of Court decisions indicates no such modification of its meaning), any holding that the loss which a taxpayer may sustain on the sale of the assets used in a trade or business (usually

the very means which make the business possible) are not to be considered "attributable" to the carrying on of such trade or business renders that crucial word devoid of all significance in the application of the limitation in question.

In the interpretation of the corresponding provision of the predepression net operating loss carryover provisions the Bureau of Internal Revenue has stated very plainly in the paragraph of Art. 651, Regulations 74, quoted above, that "included therein [the term "net loss"] are losses from the sale or other disposition of real estate, machinery, and other capital assets used in the conduct of such trade or business". In the new dispensation of the Bureau with respect to substantially similar provisions of the current statute, Section 122(d)(5), Internal Revenue Code, we find its position stated in the last paragraph of a ruling primarily on the elements of a taxpayer's return for 1944, I. T. 3711, C. B. 1945, p. 162, in the following words:

> "Although it is determined that the property upon the sale of which the loss was sustained was used in A's business of managing and operating income-producing real estate, the loss from the sale thereof is 'not attributable to the operation of a trade or business regularly carried on by the taxpayer' within the purview of section 122(d)(5) of the Code supra, since she was not a regular trader or dealer in real estate. In other words, as supported by the facts here presented, the only business *regularly* carried on by A was managing and operating her income-producing

> real estate and not trading or dealing in real estate; the property was held primarily for use, rather than for sale, in her business; and the loss did not arise or result from the operation of such business but upon the disposition of assets used therein."

Since that paragraph has been assigned the character of Holy Writ, for all intents and purposes, in the opinion in *Lazier v. United States et al., supra,* which was the sole authority cited for the affirmance by the Court of Appeals for the Fifth Circuit in the *Pettit* case, *supra,* and was a leading authority in the *per curiam* affirmance of the *Baruch* case, *supra,* it is appropriate here to look critically at the *rationale* of that low ranking, but potent, ruling, to see whether its conclusion really carries the weight of authority that has been ascribed to it.

I. T. 3711 involved a situation in which the taxpayer managed and operated numerous real estate properties as a source of income. In 1944 she sold several of the properties, with a net loss for the year resulting from the sales. The Bureau ruled that the loss was fully deductible as an ordinary loss for 1944 under the provisions of Section 117(j), Internal Revenue Code, but ruled in the paragraph quoted above that the loss from the property sales, though "ordinary", could not be used in computing an operating loss carry-over.

This ruling contains no reasoning or analysis of the statute to support this distinction made for the

first time. It simply asserts the proposition and cites six decisions, letting it go at that. Not a single one of the decisions supports the ruling. These decisions will be considered in the order cited in the ruling.

In *Slack v. Commissioner,* 35 B. T. A. 271 (1937), the taxpayer sustained a loss on the sale of real estate in 1929, and sought to include this as a "net loss" under Section 117 of the Revenue Act of 1928. That section permitted the inclusion of capital losses of non-corporate taxpayers only to the extent of capital gains. The Board sustained the Commissioner in excluding this loss *on the ground that it was a capital loss,* since under the evidence the property was not "held by the taxpayer primarily for sale in the course of his trade or business" within the terms of Section 101(c)(8) of the Act of 1928 defining capital assets.

The Board in the *Slack* case made no distinction between continued "operation" of a business and its liquidation, and to this extent the decision negatives the existence of such a distinction.

In the next case cited in I. T. 3711, *McNeir v. Commissioner,* 30 B. T. A. 418 (1934), the Board sustained the Commissioner in excluding a loss resulting from the worthlessness of stock in a realty company owning a hotel, in computing a net loss. No distinction whatever was made between "operation" and "liquidation". The Board held that the taxpayer was not engaged in a trade or business at all, so far as the property was concerned, but that the transaction was an isolated one which, even along with

others, did not amount to a trade or business. The Board said (at p. 420):

> "In the present case we are unable to find from the evidence that petitioner engaged in the trading of property with any intention of making a profit, and so we are unable to conclude that his trading amounted to a trade or business within the meaning of the taxing statute."

I. T. 3711 next cites *Estate of Green v. Commissioner,* 27 B. T. A. 1195 (1933). In this case a testamentary trust holding property for income and reinvestment in 1923 received the redemption price of a number of securities, sold some stock and sold two mortgages and one parcel of land. In excluding a loss on these transactions for purposes of computing a net loss under Section 204(a) of the Act of 1921, the Board held that the trust was simply an investor and not engaged in business atall. The Board said (at p. 1197) that the purpose of the trust was

> "* * * to conserve the estate corpus for ten years, and to protect it from the hazards of business enterprise. The whole tenor of the instrument distinctly negatives any idea that the estate should regularly carry on a business for profit, and the evidence shows, we think, that none was carried on."

Far from suggesting a distinction between the continued conduct and "sale" or "liquidation" of a business, the Board said (at p. 1196) that the question was "whether the petitioner was engaged in a trade

or business regularly carried on." In stating the question the Board omitted the word "operation", upon which the Commissioner relies here, although it was in the statute. This completely negatives any support for the distinction now sought to be made.

The next case cited by I. T. 3711 is *Anderson v. United States,* 48 F. (2d) 201 (C. C. A. 5th, 1931). Here the taxpayer sustained a loss from the failure of a company in which he had invested, lending it more money as its business declined. Upon the clear evidence the Court held that he had simply sustained an investment loss and was not engaged in business at all, pointing out (at p. 202) that the statute "was not intended to apply to isolated or occasional losses such as here shown."

The fifth case cited by I. T. 3711 is *Pabst v. Lucas,* 36 F. (2d) 614 (D. C. App. 1929). Here too, the asserted net loss was based on miscellaneous personal losses, personal loans, contributions, and investment losses. These were disallowed for obvious reasons, no evidence of a regular business being present.

The final case cited by I. T. 3711 is *Lloyd v. Commissioner,* 32 B. T. A. 887 (1935). Here the inclusion of losses on sales of real estate was allowed in computing a net operating loss. It thus fails to support any argument for exclusion. On the contrary, in commenting on Section 117(a)(1) of the 1928 Act (same as the present Section 122(d)(5) of the Code) the Board said (at p. 891):

> "If the loss results from *or is incidental* to the operation of a trade or business regularly carried on by the taxpayer, it is sufficient to bring it within the net loss provisions of the statute." (Emphasis supplied.)

Far from supporting a distinction between "operation" and "sale" of a business, this quotation points out that a loss *incidental* to the operation of a business may be included. In a very real sense it can be said that the sale of assets used in business, a possibility inherent in the conduct of any business, is certainly at least "incidental" to its operation.

The foregoing analyses of the cases cited by the draftsman of I. T. 3711 emphasize the fallacious nature of his conclusion rather than support such conclusion. The first five such cases involve the exclusion of losses on stocks or similar investments, or bad debt losses, which the Board of Tax Appeals, or other trial Court, had held, as matters of primary fact, to be not attributable to any business regularly carried on by the taxpayers involved. In each case the exclusion was justifiable as a simple point of classification on the basis of evidence or stipulations, and in none of them did the opinions overrule to the slightest extent the provisions of Art. 651, Regulations 74 (quoted in our argument under Proposition II above), or the corresponding provisions in Art. 1621, Regulations 69 and 65, or in Art. 1601, Regulations 62, either directly or by implication.

Also there is pointedly omitted from I. T. 3711 any reference to the leading case on the exclusion of casual

and unrelated investment and bad debt losses, *Dalton v. Bowers,* 287 U. S. 404 (1932), 53 S. Ct. 205, 77 L. Ed. 389, or the same case in the lower Court, 56 F. (2d) 16 (C. C. A. 2, 1932). The reason for such avoidance is, we may surmise, found in the reference in each of those opinions to the provisions of Art. 1621, Regulations 65, the words of which we have quoted above as from Art. 651, Regulations 74, and the actual quotation at 56 F. (2d) 18 of a part of the sentence which we have quoted above. To have called attention to that sentence would have weakened the specious thesis of I. T. 3711 that Section 122(d)(5), Internal Revenue Code, means something different from what it plainly says.

We have taken so much time to expose the fallacy of *non sequitur* into which the draftsman of I. T. 3711 fell in his zeal to advance a new dispensation by the Bureau of Internal Revenue in the matter of its administration of the relief measures of Section 122, I. R. C., because of the importance his conclusions have assumed in the opinions of three Circuit Courts of Appeal on the question there involved, as well as the close parallel to those conclusions found in the other basic ruling on the question in the Tax Court's opinion, by Judge Leech, in *Joseph Sic,* 10 T. C. 1096. In that very brief opinion Judge Leech has, by a somewhat different process, as we shall show below, justified the conclusion of I. T. 3711 to an equally fallacious result.

Admitting that Section 122(d)(5), I. R. C. "does not materially differ from the language contained in

Section 206 of the Revenue Act of 1924" (p. 1098), the opinion goes on to cite *Dalton v. Bowers, supra,* in support of the exclusion of the taxpayer's loss from the sale of farm land. In so doing Judge Leech completely overlooked the Circuit Court's ratification of the Commissioner's interpretation of the clause "attributable to the operation of a business regularly carried on" in Art. 1651, Regulations 65, quoted with approval in the Circuit Court's opinion at 56 F. (2d) 18, and the inferential approval of that ratification in the Supreme Court. Instead of being a precedent and authority for the Bureau's new dispensation interpretation of the similar clause in Section 122(d) (5), *Dalton v. Bowers, supra,* was just about as squarely on the other side as it could possibly be. The opinion not only ignores the plain words of the Commissioner's interpretation of the crucial clause in all of the pre-depression regulations down to Art. 651, Regulations 74, but it cites as authority for a contrary finding as to what that interpretation was a case which in the Circuit Court stage thereof specifically ratified and approved the language of the Regulations.

This opinion of Judge Leech and that of the anonymous draftsman of I. T. 3711 are unfortunately the twin pillars of the doctrine exemplified by the cited opinions of the Courts of Appeals for the Eighth, Fifth, and Second Circuits in the *Lazier, Sic, Pettit,* and *Baruch* cases, *supra;* and how flimsy support they turn out to be on examination of the materials of

which they are constructed! In the light of our showing here of the deficiencies of those basic opinions it is respectfully submitted that this Court of Appeals should disregard the precedental character of those cases and render its decision according to the clear intent of the Congress in enacting Section 122 of the Internal Revenue Code.

IV. THE TERMS OF SECTION 122, INTERNAL REVENUE CODE, DO NOT PROVIDE OR IMPLY THAT LOSSES OF INDIVIDUALS FROM DISPOSAL OF PROPERTY USED IN TRADE OR BUSINESS BE TREATED DIFFERENTLY FROM SUCH LOSSES BY CORPORATIONS.

Section 122(d)(5) is explicitly applicable to individuals only and not to corporations. Was it the intention of the Congress to allow carry-over liquidation losses of corporations while not allowing them to individuals in business? The right of corporations to carry-overs and carry-backs of losses resulting in the liquidation of its assets and winding up of its affairs has been clearly determined by the Tax Court in the cases of *Northway Securities Co.*, 23 B. T. A. 532 (1931), and *Acampo Winery and Distilleries, Inc.*, 7 T. C. 629 (1947), which decisions have been formally acquiesced in by the respondent. Thus it is clear that the Bureau of Internal Revenue's contrary new dispensation with respect to individuals is not based on any broad concept of tax law as to the function of loss carry-overs and carry-backs but is limited to the interpretation of the language of the statute itself.

It hardly requires argument to show that there is nothing in the distinctions under the income tax law between individuals and corporations which should lead to their different treatment in this respect. Nor is there anything in the Code itself to suggest a reason for such different treatment.

The reason for the application of the limitations in Section 122(d)(5) only to individuals is presented very simply in Section 23 of the Code, which section provides generally for all deductions from gross income, including in Section 23(s) the deduction of net operating losses, the provisions of Section 122 merely providing the definitions, limitations, and prescription for computation of such losses in implementation of Section 23(s). Under Section 23(f) all losses of corporations are specifically treated as business losses. Under Section 23(e), however, individuals have their losses classified into three classes, viz., (1) those "incurred in trade or business", (2) those "incurred in any transaction entered into for profit, though not connected with the trade or business", and (3) those "of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft." The first class is set off from the other two by the exceptions in the definitions in the latter of losses or property "not connected with the trade or business". The implication is clear that the intent of Section 122(d)(5) is to make the same distinction between losses incurred in and connected with the trade or business

and those otherwise incurred or suffered. It was exactly that distinction carried through the relief provisions of Section 117(j) of the Code that led the draftsman of I. T. 3711 to conclude that the taxpayer's losses in that case were deductions from her ordinary income for the year sustained, and it was his blindness to it which led to his fallacious conclusion that they were to be excluded in the computation of a net operating loss.

If, within this classification of losses allowable to individuals, there was anything peculiar to losses resulting from the sale of property used in a business, which justified their exclusion in computing a net operating loss, the peculiarity would be one equally applicable to corporations and to individuals. Permitting them for corporations demonstrates that the only limitation intended in Section 122(d)(5) was to exclude individual losses "not connected with the trade or business".

It has been stipulated in this proceeding that the petitioners were in the business during 1944 and 1945 of operating a dairy farm. (Stip. Par. (5), R. 24.) The cattle and farm equipment subject of the losses here in question can hardly be said to have been acquired, owned, kept, sold, or otherwise disposed of, in transactions "not connected with the trade or business" so as to take losses pertaining to them out of the classification of Section 23(e)(1), "of losses incurred in trade or business", and to put them in either of the classifications of Section 23(e)(2) or 23(e)(3).

The foregoing exposition of the bases of distinction of the different kinds of losses, like our analysis in the argument under Proposition III above of the basic principles affecting the construction of Section 122(d)(5), demonstrates the wholly artificial and non-statutory character of the asserted distinction between losses in the continued operation of a business and those in the liquidation and winding up thereof. In the decided cases in which the distinction has been made and sustained, the logically and legally weak reasons for the distinction have always been clinched by a finding that the taxpayer was not in the "business regularly carried on" of selling out his property, i.e. dealing in fixtures, in real estate, farm equipment, etc., a finding that is sophistic and unrealistic to the *n*th degree, as if such a "finding" could in any wise alter the obvious fact that losses sustained in such final acts of winding up a business were most positively "connected with" and "attributable to" the conduct of the business. The artificial character of the asserted distinction is confirmed by the commercial and economic reality that the sale or liquidation, be it at a loss or at a profit, is an integral part, albeit the concluding step, of the business operation. The respondent would not question the repeated occurrence of a net operating loss in successive years in a losing business so long as the business continued. The taxpayer might continue to conduct such a business, losing more each year until its value had been reduced to *zero*. Should he be treated less favorably because,

after some years of losses, he come to his senses and gets the misery over with by selling out?

From a business point of view the final sale cannot be isolated because, as a practical matter, it represents the final culmination and realization of factors of the continued operation at a loss. In this sense the sale at a loss is directly incidental to and, in the language of Section 122(d)(5), "attributable" to such operation. In another connection, that of the interpretation of the distinction between "business bad debts" and "non-business bad debts" in Section 23(k), I. R. C. (new with the Revenue Act of 1942), the respondent advances the very opposite concept, in Section 29.23 (k)-6, Regulations 111, in instance (6) with reference to an example of A, engaged in the grocery business, extending credit on open account to B in 1941 (at the bottom of page 122, Treasury Department print), which reads:

> "(6) In 1942, A, *in liquidating the business,* attempts to collect B's claim but finds that it has become worthless. A's loss is not controlled by the non-business debt provisions, since *a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.*" (Emphasis supplied.)

It is only fair to individuals in the Bureau service, such as the draftsman of I. T. 3711, who have a different view of what is "connected with", "attributable to", or "proximately incident to" the conduct of business, that this entire example is not original

with the Bureau but has been copied *verbatim* from the related reports of committees of the Congress, a fact which does not, however, weaken its import.

CONCLUSION.

In view of our showing above (1) that the modification by the Revenue Act of 1942 of the operating loss deduction to include "carry-backs" of losses was a relief measure to be construed liberally in favor of taxpayers, (2) that the history of the net operating loss provisions of the income tax law indicates no intention to exclude from the "net operating loss" losses incurred in the disposal of assets used in the trade or business, (3) that the terms of Section 122, Internal Revenue Code, do not provide or imply that losses incurred in the disposal of assets used in the trade or business shall be excluded in computing a net operating loss, and (4) that the terms of that section further do not require or imply that losses of individuals from disposal of property used in trade or business be treated differently from such losses of corporations, it is prayed that this Court of Appeals may reverse the finding of the Tax Court that no loss carry-back from 1945 is valid to eliminate the petitioners' income and victory tax liability for 1943. This prayer is made notwithstanding the force of precedents in opinions of Courts of Appeals for the Fifth, Eighth, and Second Circuits because of the demonstrated weakness of those precedents on anal-

ysis of their foundation on a Bureau ruling, I. T. 3711, and on the opinion of Judge Leech of the Tax Court in *Joseph Sic,* 10 T. C. 1096, the fallacies of which ruling and opinion are exposed above.

Dated, Stockton, California,
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Respectfully submitted,
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